

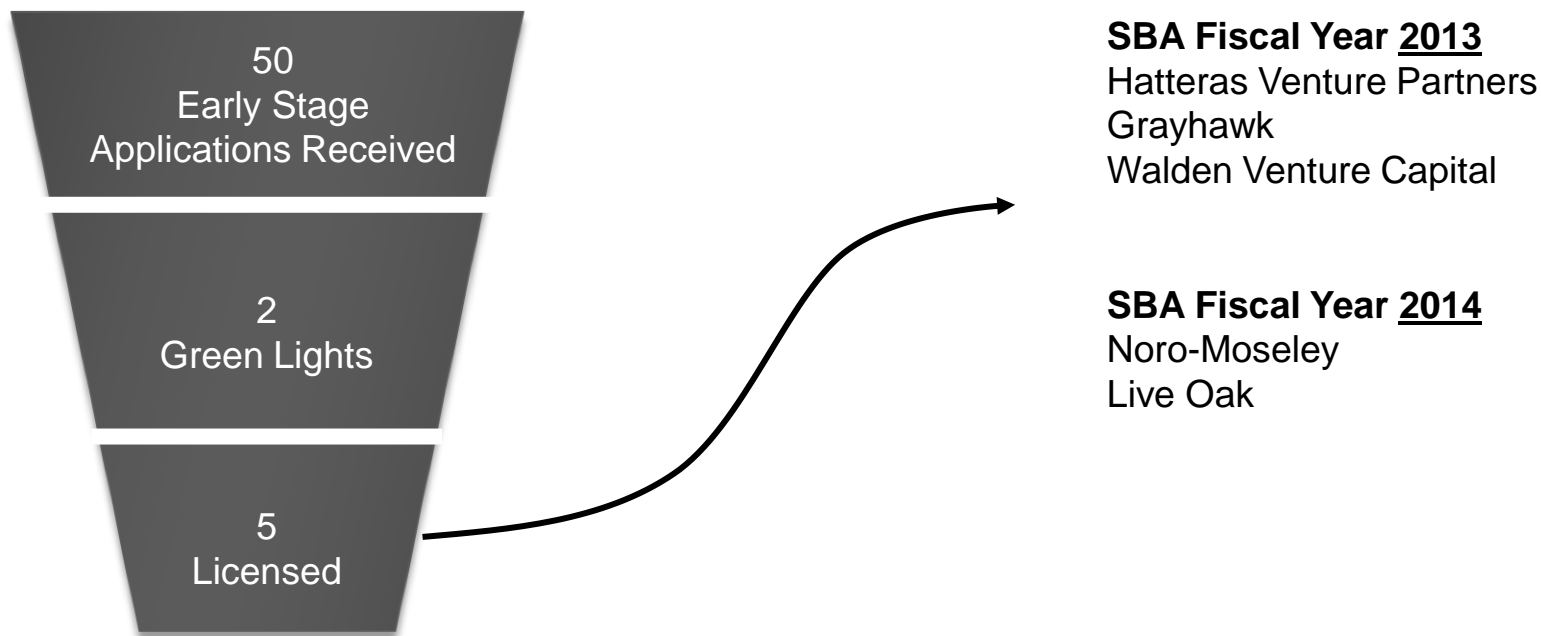
# Introduction to the Early Stage Investment Initiative



The Early Stage Investment Initiative launched in 2011 as part of President Obama's Startup America Initiative. The program is in year three of a five year plan to commit \$200M annually to venture capital firms investing in high growth US small businesses.

# Progress To-Date

The five funds SBA has licensed to date are geographically diverse and target different industries.



# Early Stage SBIC Key Terms

Terms	Early Stage Debenture
Licensing	Annual Call Commitments limited to \$200 million per year up to \$1 billion total SBA has right to diversify across vintage years & geography
Private Capital	\$20 million minimum
Investments	50% of investment dollars into early stage (not yet achieved positive operating cash flow in any fiscal year prior to 1 <sup>st</sup> financing)
Maximum Leverage	Up to one (1) tier of leverage, no greater than \$50 million Half tier of leverage (or less) encouraged
Term	Ten year maturity that may be repaid in full at any time without penalty
SBA Fees	1% Commitment Fee 2% Draw Fee Annual Fee paid quarterly with interest payments Licensing Fee: \$25,000 Examination Fees: Per 107.692

# Early Stage SBIC Key Terms (continued)

Terms	Early Stage Debenture
Leverage Description	<p><b>Standard Early Stage Debenture:</b></p> <ul style="list-style-type: none"> <li>• Interest &amp; charges due and payable quarterly</li> <li>• Requires 5 years interest reserve (may be held as unfunded private capital commitments or in restricted cash)</li> </ul> <p><b>Or</b></p> <p><b>Discounted Debenture:</b></p> <ul style="list-style-type: none"> <li>• Interest &amp; charges discounted for first 5 years</li> <li>• Quarterly interest &amp; charges payable after first 5 years</li> </ul>
Distributions	<p><b>Per § 107.1180, but in general:</b></p> <ul style="list-style-type: none"> <li>• Interest &amp; charges must be paid prior to distribution</li> <li>• Below 50% Capital Impairment Percentage (“CIP”): Pro Rata on <b>cumulative</b> basis</li> <li>• At or above 50% CIP and above half a tier of leverage or Above Maximum CIP (generally 70% CIP): SBA gets distribution priority</li> </ul>
Other Key Terms	<p>Annual Examinations</p> <p>Above 50% CIP</p> <ul style="list-style-type: none"> <li>• SBA has specific right to require valuations on your investments.</li> <li>• SBA takes all distribution priority if over half a tier of leverage</li> </ul> <p>Above Maximum CIP (Generally 70% CIP)</p> <ul style="list-style-type: none"> <li>• SBA has right to promptly transfer SBIC to Office of Liquidation</li> </ul>

# Important Dates

Milestones	Dates/Times
FAQ Process Closed	5 p.m. Eastern Time (“EST”) on March 28, 2014
<b>Initial Review Period</b>	
Management Assessment Questionnaires (“MAQs”) Due	5 p.m. EST—March 28, 2014
Interview Period	May 26, 2014—June 5, 2014
Anticipated “Green Light” Decision	May 26, 2014—June 5, 2014
<b>Licensing Periods</b>	
For funds with \$20M of Regulatory Capital seeking a license in FY 2014	5 p.m. ET June 30, 2014
Anticipated Licensing Date for FY 2014 funds	September 30, 2014
All other funds have 12 months from receipt of a Greenlight to submit their license application	Rolling Process
<b>Notes:</b> <ul style="list-style-type: none"> <li>SBA reserves the right to extend its interview, due diligence, committee, and approval timelines as appropriate. SBA will update its website at <a href="http://www.sba.gov/inv/earlystage">www.sba.gov/inv/earlystage</a> should these dates change. Applicants will be notified by e-mail should these dates change.</li> <li>SBA expects to issue additional calls for Early Stage Fund Managers on an annual basis. SBA will announce these calls via a call notice in the Federal Register.</li> </ul>	

# Small Business Investment Requirements

- ▶ **50% in Early Stage companies – not yet profitable as of the investment date.**
  - ▶ Subsequent investments count toward 50% Early Stage requirement – even after the company becomes profitable.
- ▶ **Remaining 50% in US Small Businesses, defined as:**
  - ▶ Businesses with a tangible net worth < \$18 million AND average after-tax income for prior two years of < \$6 million.
  - ▶ OR Businesses that qualify as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally under 500 employees).

# Risk Mitigation Strategies

- ▶ **Early Stage SBA leverage can be an inexpensive option for additional capital, both before and after it is drawn**
  - ▶ EX:
    - ▶ Private Capital - \$50M
    - ▶ Half Tier of Leverage - \$25M
    - ▶ Fees:
      - Licensing Fee - \$25K
      - 1% commitment fee - \$250K
    - ▶ Option:
      - \$275K - \$25M SBA leverage option
  - ▶ As funds draw leverage, they pay a 2% draw down fee, an Annual Charge (currently 0.355%) on drawn capital, additional nominal fees, and quarterly interest on drawn capital beginning in year six (6). The interest rate is set quarterly by the FHLBC. Please refer to the interest rate calculator at <http://www.fhlbc.com/Documents/sbacalculatorpage.htm> for a more specific estimate of applicable rates. The rate is currently around 4%.

# Risk Mitigation Strategies

- ▶ **Applicants may request less than a full tier of leverage**
  - ▶ Unlike the regular debenture program, SBA will not take distribution priority if your Capital Impairment (“CIP”) is above 50%, but below the maximum allowable CIP of 70% (See CIP example in the Appendix below).
- ▶ **Use debenture leverage prudently**
  - ▶ For the 50% of total capital that must be invested in Early Stage companies, consider drawing SBA leverage later in your fund’s life to invest in companies at a positive inflection point – e.g., about to turn the corner to profitability.
  - ▶ For the remaining 50% of total capital that must be invested in US Small Businesses, consider drawing SBA leverage to make follow on investments in proven winners at or near a liquidity event.



# Risk Mitigation Strategies

- ▶ **Charge a management fee on Regulatory Capital only**
  - ▶ To address concerns by LPs about management fees being charged in addition to SBA fees, funds may lower management expenses by only charging a management fee on Regulatory Capital.
  - ▶ Allowable management fees are dictated by Technote 7a.
- ▶ **Structure some investments with a current pay component**
  - ▶ Current pay investments reduce J-curve depth, and provide yield to service SBA leverage.

# Contact Us

## **U.S. Small Business Administration**

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### **Visit Us Online:**

[www.sba.gov/inv/earlystage](http://www.sba.gov/inv/earlystage)

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# Appendix to Early Stage SBIC Presentation

# What is CIP?

- ▶ CIP is the key regulatory metric SBA uses to determine an SBIC's financial health.
- ▶ CIP is defined by 13 CFR 107.1840, but *in general*
  - ▶ Represents operating and investment losses as a percentage of private regulatory capital.
  - ▶ Realized losses can typically be offset by unrealized appreciation only in qualifying securities:
    - ▶ 80% of Class I (Publicly traded and marketable securities)
    - ▶ 50% of Class II (Privately held securities that received a substantial investment by outside investor within past 24 months).
  - ▶ Other securities (not qualifying as Class I or Class II) cannot offset realized losses, but can offset unrealized losses.
- ▶ Maximum allowable CIP
  - ▶ Depends on leverage ratio (leverage to Private Regulatory Capital) and the percentage of equity
  - ▶ Typically 40 to 50% for most SBICs issuing Debentures

# CIP Example

- ▶ Private Regulatory Capital = \$25 million
- ▶ Operating & Investment Realized Losses = -\$10 million
- ▶ Net Appreciation = \$5 million
  - ▶ Depreciation = \$3 million
  - ▶ Appreciation = \$8 million as follows:
    - ▶ Class I - \$1 million
    - ▶ Class II - \$2 million
    - ▶ Other - \$ 6 million

*Note: This equation changes based on amounts of Class I and II relative to Net Appreciation.*

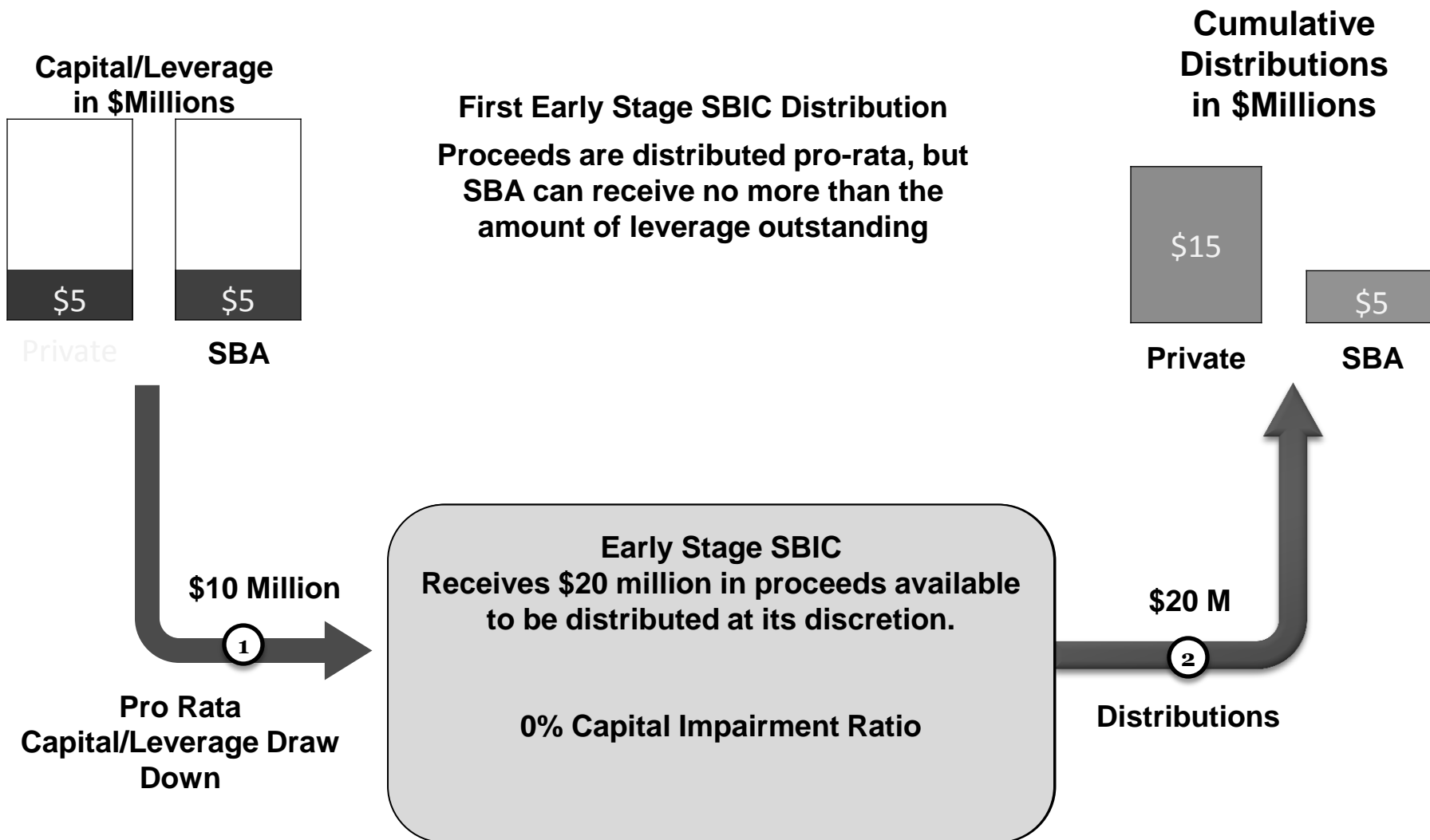
$$\text{CIP} = - \left[ \frac{-\$10 \text{ million} + 80\% \times \$1 \text{ million} + 50\% \times \$2 \text{ million}}{\$25 \text{ million}} \right] \times 100$$

**= 32.8%**

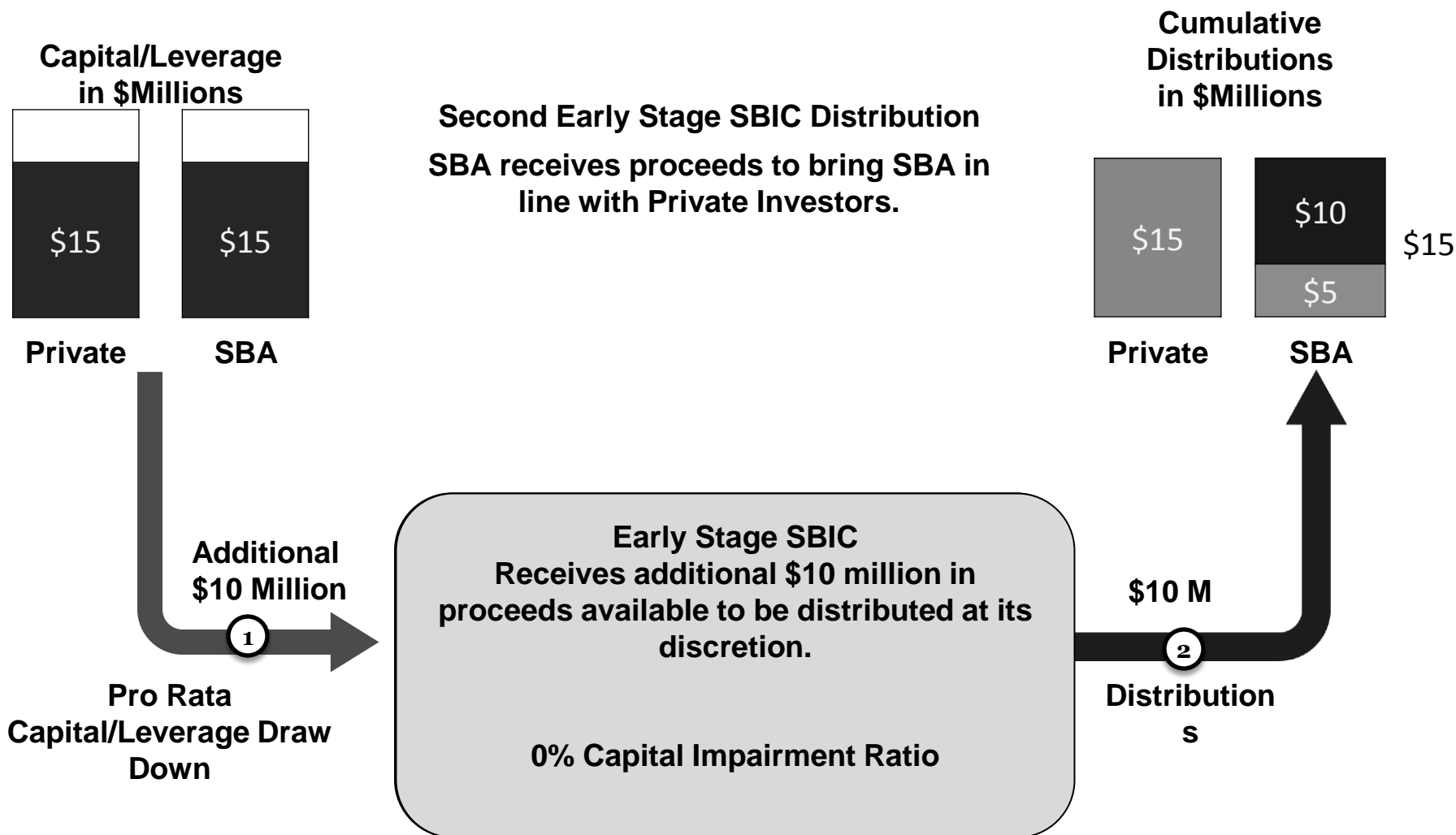
# Key SBA Rights if SBIC's CIP Over Maximum Allowable

- ▶ Deny leverage commitments and draws
- ▶ Transfer to the Office of Liquidation
- ▶ If settlement cannot be reached in Liquidation, SBA may utilize receivership
- ▶ 13 CFR Part 107, Subpart J discusses SBA's rights in conjunction with a Licensee's Noncompliance With Terms of Leverage

# Early Stage Distribution Example 1: SBA Catch-Up First Distribution

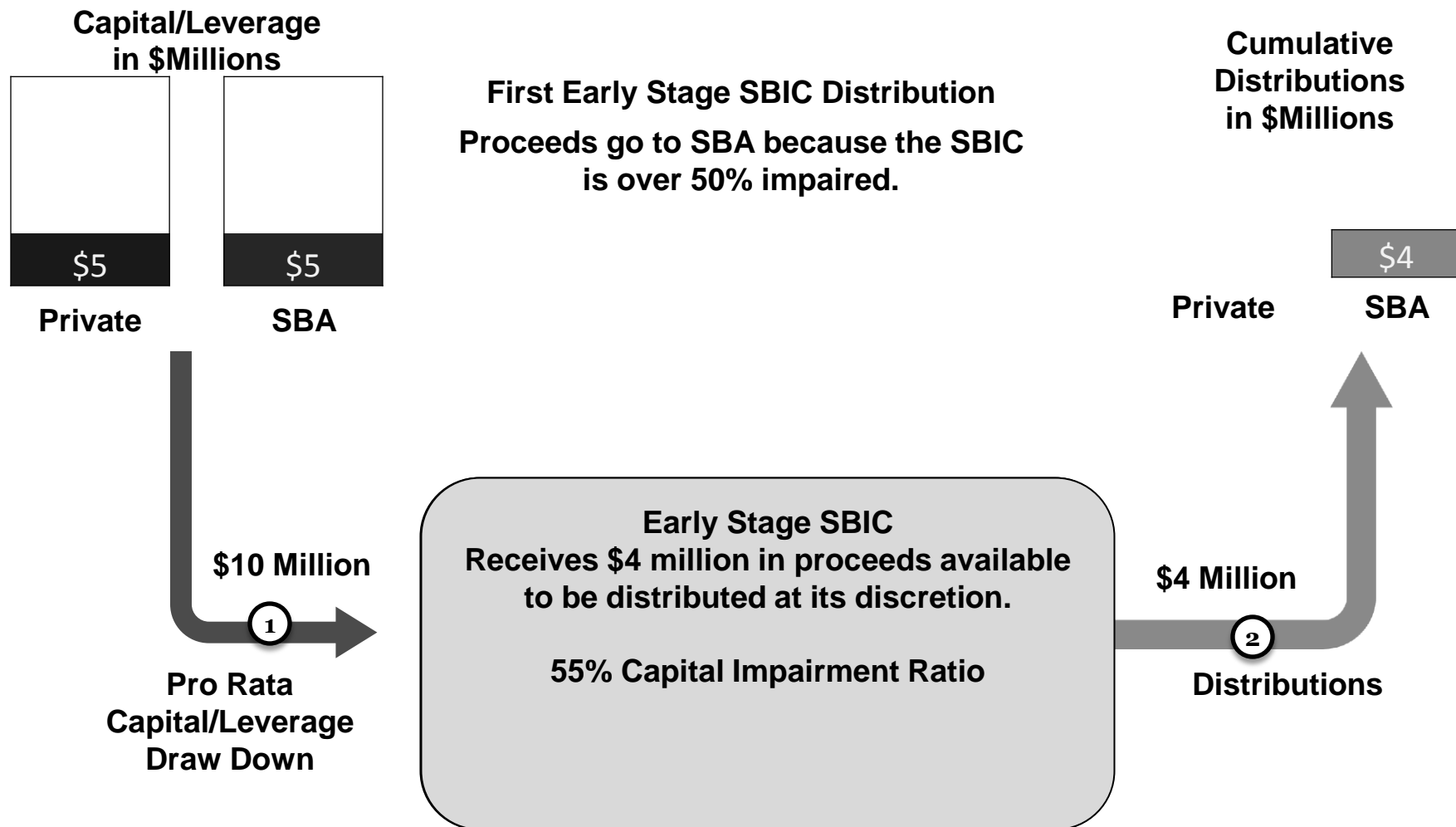


# Early Stage Distribution Example 1: SBA Catch-Up Second Distribution





# Early Stage Distribution Example 2: LP Catch-Up First Distribution



# Early Stage Distribution Example 2: LP Catch-Up Second Distribution

